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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 339

HENRIETTA O. MURDOCH, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 2a-12a)[1] are not officially reported.[2] The opinion of the court of appeals (Pet. 12-16) is not yet officially reported.

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[1] "R." references are to the appendix to Henrietta O. Murdoch's brief in the Court of Appeals.

[2] *Murdoch* v. *Commissioner*, decided August 16, 1962 (P-H Memo T.C., par. 62,196).

JURISDICTION

The judgment of the Court of Appeals was entered on June 7, 1963. (Pet. 12.) A petition for rehearing was denied on July 8, 1963. (Pet. 2.) The petition for a writ of certiorari was filed on August 5, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court of appeals correctly held that substantial evidence supports the conclusion of the Tax Court that a portion of the amount paid in settlement of litigation covered claims for alleged loss of profits and was therefore taxable as ordinary income rather than as a capital gain.

STATUTE INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;

* * * *

(5) Rents;

* * * * *

(7) Dividends;

* * * * *

(26 U.S.C. 1958 ed., Sec. 61.)

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

* * * * *

(26 U.S.C. 1958 ed., Sec. 1221.)

STATEMENT

Henrietta O. Murdoch and her brother-in-law, John P. Murdoch, each owned 49 per cent of the stock of John P. Murdoch Company (R. 2a-3a.) Mr. Murdoch, the president, a director, and the actual manager of their family corporation, was dissatisfied with the arrangement whereby he did all the work but Mrs. Murdoch received one-half of the profits; he told

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Henrietta inherited her 49 per cent interest upon the death of her husband, Eugene Murdoch, in September, 1945. (R. 2a-3a.)

her that unless some suitable arrangement was worked out he would "close the business." (R. 3a-4a.) Sometime shortly after September, 1945, John P. Murdoch and Mrs. Murdoch agreed that the Murdoch Company's physical assets (real estate and production equipment) would be transferred to a new corporation—the 3630 Haverford Avenue Corporation ("3630")—in exchange for the latter's stock, 49 per cent of which was to be issued to Henrietta Murdoch and the other 49 per cent to John P. Murdoch and his wife. (Pet. 12.) Upon receipt of the 3630 stock, Mrs. Murdoch transferred to John P. Murdoch her 49 per cent interest in Murdoch Company, giving him 98 per cent of that company's stock. (R. 5a.)

On December 31, 1946, 3630 leased its physical assets to Murdoch Company for $1,200 per year plus taxes and mortgage interest. This rental arrangement continued until April 1, 1955, when the rent was increased to $5,000 per year without the obligation of the lessee to pay taxes or interest. (Pet. 12.)

In June, 1955, Mrs. Murdoch instituted an equity action against Mr. Murdoch in a Pennsylvania court. She alleged, *inter alia*, that she was fraudulently induced to exchange her 49 per cent interest in Murdoch Company for the 49 per cent interest in 3630, and that the annual fair rental value of the physical assets leased by 3630 to Murdoch Company was $6,500, not $1,200. (Pet. 12-13; R. 6a-7a.) Mrs. Murdoch demanded of John P. Murdoch (Pet. 13; R. 8a):

(a) * * * an accounting of all the profits made by him by virtue of his ownership of 50% of the stock of the John P. Murdoch Company since the 1st day of January, 1945.

(b) 49% of the fair rental value of the real estate and machinery leased by the 3630 Haverford Avenue Corporation to the John P. Murdoch Company from December 31, 1946 until December 31, 1954.

(c) A complete accounting of all transactions of the John P. Murdoch Company and the 3630 Haverford Avenue Corporation from the 1st of January, 1945 to date.

(d) Such other and further relief as this court may deem appropriate in the premises.

The litigation was settled before trial, on December 11, 1957, for $36,500. Mrs. Murdoch executed two documents. One was designated a "Release" and provided for the payment to her of $16,500 in return for her release of all claims against John P. Murdoch, the Murdoch Company, and 3630. (R. 8a-9a.) The other document, designated a "Bill of Sale," provided that Mrs. Murdoch assign to Mr. Murdoch her 3630 stock in return for $20,000. Mr. Murdoch gave separate checks covering these transactions. A $16,500 check stated on its face: "Payment in release of all claims in suit of Murdoch v. Murdoch, C.P.I." The other check was for $20,000 and was marked "Payment in full for 49% shares 3630 Haverford Ave. Corp. stock." (Pet. 13-14.)

In her income tax return for 1957, Henrietta O. Murdoch reported the $36,500 ($16,500 plus $20,000) received from Mr. Murdoch as proceeds from the

sale of "John P. Murdoch Co." and the gain therefrom as long term capital gain. The Commissioner, however, determined (1) that the $16,500 payment represented ordinary income and (2) that Mr. Murdoch could not deduct it. (R. 10a, 11a.) The Tax Court upheld the Commissioner's treatment of the $16,500 as ordinary income, but held that Mr. Murdoch could deduct the amount. The court stated (R. 11a-12a):

> The Government recognizes that these determinations are inconsistent and does not seek to have both of them sustained. The real parties litigant are Henrietta and John. We sustain John's version of the transaction, with the consequence that the $16,500 payment must be treated as ordinary income to Henrietta and deductible by him.
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> * * * *
>
> The $16,500 payment was received in compromise of Henrietta's equity suit against John. Its taxable nature must be considered in the light of the claim from which it arose. The main thrust of her complaint was an accounting from John in respect of profits to which she, somehow or other, claimed to be entitled. The $16,500 payment was in response to that claim. It was not consideration for a capital asset, and was taxable to her as ordinary income.

The court of appeals affirmed (Pet. 12-16). It held (Pet. 15-16) that there was substantial evidence to support the Tax Court's conclusion that the $16,500 payment to Mrs. Murdoch "was in settlement of her demand upon Mr. Murdoch to account to her for

profits to which she claimed to be entitled" and therefore was taxable as ordinary income.

ARGUMENT

As petitioner herself recognizes (Pet. 7-9), there is no conflict and the case presents only the narrow question whether the law was correctly applied to the facts of this case. The governing principle is clear: as both courts below correctly held (Pet. 15; R. 11a-12a), whether amounts received in settlement of a lawsuit are capital gains or ordinary income depends upon the nature and basis of the claims which are settled. *Carter's Estate* v. *Commissioner*, 298 F. 2d 192, 195 (C.A. 8), certiorari denied, 370 U.S. 910; *Sager Glove Corp.* v. *Commissioner*, 311 F. 2d 210, 211 (C.A. 7), certiorari denied, 373 U.S. 910; *Raytheon Production Corp.* v. *Commissioner*, 144 F. 2d 110, 113-114 (C.A. 1), certiorari denied, 323 U.S. 779; cf. *United States* v. *Gilmore*, 372 U.S. 39; *United States* v. *Patrick*, 372 U.S. 53; *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426. Where, as in the present case, the claim that was settled was for loss of alleged profits, the amount paid in such settlement represented compensation for the income which had been lost, and is therefore properly treated as ordinary income rather than as capital gain.

The record fully supports the Tax Court's conclusion that the $16,500 payment was made "in response to" petitioner's claim that she was entitled to "an accounting from John in respect of profits to which she * * * claimed to be entitled" (R. 11a-12a).

Petitioner's complaint in the State court charged that Mr. Murdoch had defrauded her and sought, among other things, an accounting of profits and 49 per cent of the fair rental of the Murdoch Company's physical assets (R. 7a-8a). The settlement consisted of two separate, although obviously related, transactions: the payment of $16,500 for release of all claims against the two companies and Mr. Murdoch personally, and the assignment of Mrs. Murdoch's 3630 stock in return for $20,000. Separate checks were given for each transaction. The Tax Court was justified in concluding in these circumstances, and in the absence of any contrary evidence by petitioner, that the $16,500 payment was, as the court of appeals stated (Pet. 15), "in settlement of her demand upon Mr. Murdoch to account to her for profits to which she claimed to be entitled." There is no occasion for further review of that issue.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

DAVID O. WALTER,
ALAN D. PEKELNEY,
Attorneys.

SEPTEMBER, 1963.